Supreme Court, U.S.
FILED
MAY 6 1987
JOSEPH F. SPANIOL, JR.
CLERK

No. 86-751

IN THE

Supreme Court of the United States

OCTOBER TERM, 1986

ARKANSAS BEST CORPORATION AND SUBSIDIARIES,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF OF THE NATIONAL COUNCIL OF FARMER COOPERATIVES AS AMICUS CURIAE

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INTEREST OF THE NATIONAL COUNCIL OF FARMER COOPERATIVES

The National Council of Farmer Cooperatives ("NCFC"), with the consent of the parties,[1] submits this Brief as *Amicus Curiae* in support of Appellant's position that the United States Court of Appeals for the Eighth Circuit was in error when it held that capital stock must always be treated as a capital asset without regard to the reasons the stock was purchased and held.[2]

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[1] Copies of our letters to counsel for the parties to this case requesting their permission to file an *amicus* brief and their favorable responses accompanied this brief when filed.

[2] *Arkansas Best Corporation* v. *Commissioner*, 800 F.2d 215 (8th Cir. 1986) rev'g. in part and aff'g. in part 83 T.C. 640 (1984).

(footnote continued on next page)

The NCFC is a nationwide association of businesses operated on a cooperative basis which are owned and controlled by farmers. Its membership includes 90 major marketing and farm supply cooperatives, the 37 banks of the Farm Credit System,[3] and 33 state councils of farmer cooperatives. The members of the NCFC handle nearly every type of agricultural commodity produced in the United States, market these commodities domestically and around the world and furnish production supplies and credit to their farmer members and patrons. The membership of the members of NCFC includes approximately 90 percent of the nearly 5,600 local farmer cooperatives in the nation.

Farmer cooperatives were formed, and operate today, to meet the needs of farmers for reliable and fairly-priced sources for farm supplies (such as, fertilizer, seed, feed and pesticides) and farm services and to provide farmers assistance in effectively marketing the commodities that they produce. These cooperatives are an integral extension of the farming operations of their members. Their importance to agriculture is demonstrated by the fact that five out of six American farmers are affiliated with one or more cooperatives.

What distinguishes cooperatives from other businesses is that a cooperative's earnings inure directly to the benefit of its patrons, not to its shareholders. Cooperatives distribute their earnings each year in the form of patronage dividends based upon the quantity or value of business done with or for each patron.

(footnote continued from preceding page)

The only exception recognized by the Eighth Circuit was for security dealers holding capital stock in inventory who are subject to the rules of Code section 1236.

[3]The Farm Credit System consists of the 12 district Federal Land Banks, the 12 district Federal Intermediate Credit Banks, the 12 district Banks for Cooperatives and the Central Bank for Cooperatives all of which are Federally chartered and governed by the Farm Credit Act and the Farm Credit Administration.

Farmer cooperatives are incorporated and issue capital stock to their members. However, that stock does not represent an "investment" by their members as that term is commonly used. Normally, cooperative stock is entitled to no dividends. As noted, earnings of a cooperative are distributed on the basis of patronage, not stock ownership. Usually, cooperative stock has no appreciation potential since it is sold at par and is entitled upon liquidation to receive an amount equal to its par value and no more. Residual assets on liquidation normally are distributed on a patronage basis. In most cases, cooperative stock is subject to restrictions on transferability and there is no market for the stock. Usually, members are required to buy stock in a cooperative before they can patronize the cooperative. They may receive additional shares of capital stock as a portion of their patronage dividends. Given the characteristics of cooperative stock and the conditions under which members obtain it, it is clear that members acquire and hold the stock for business, not investment, purposes.

The Internal Revenue Service has publicly recognized the unique features of the stock of cooperatives. *Rev. Rul. 78-402*, 1978-2 Cum. Bull. 138, held that stock purchased by a retailer in a cooperative wholesaler "was purchased and held predominantly for purposes related to the conduct of the . . . [retailer's] business, and not predominantly, for investment purposes." The ruling stated:

> ". . . the purchase and holding of the common stock of the cooperative by **X** was predominantly related to the conduct of the . . . [retailer's] business since it permitted **X** to avail itself of the cooperative's purchasing power, supply of products, and business services. In addition, no dividends were payable with respect to the stock, and because the cooperative stock was purchased at par and redeemable at the lower of par or book value, the optimum return **X** could expect to receive upon its redemption was the par value purchase price."

1978-2 Cum. Bull. 138, at 138-9.

Recently in *Ltr. 8713055* (December 30, 1986),[4] the Internal Revenue Service cited *Rev. Rul. 78-402* and contrasted the facts in that ruling with the Eighth Circuit decision in *Arkansas Best.*

Many cooperatives pay a portion of their patronage dividends each year in the form of written notices of allocation that inform each member that earnings have been allocated to the member on the books of the cooperative. The Internal Revenue Service has ruled that such notices are the equivalent of equity. *Rev. Rul. 69-216*, 1969-1 Cum. Bull. 109 and *Rev. Rul. 70-298*, 1970-1 Cum. Bull. 82. Provided certain formalities are followed, pursuant to Subchapter T (26 U.S.C. §§ 1381-1388) of the Internal Revenue Code of 1986 (hereinafter referred to as "Code") a cooperative is entitled to exclude from its income patronage dividends paid to members in this form, and members are required to include the notices in ordinary income at the face amount (without regard to fair market value). Usually the notices have no dividend rights or appreciation potential.

Rev. Rul. 70-64, 1970-1 Cum. Bull. 36, held that a chicken farmer recognized an ordinary loss when a cooperative redeemed notices of allocation at less than face which had been distributed to the farmer as part of his patronage dividend from the cooperative. The ruling stated:

> "In the instant situation the taxpayer joined the cooperative to facilitate his business and to make it more profitable. The transaction that gave rise to the issuance of the notice of allocation arose in the ordinary course of taxpayer's trade or business. Accordingly, the loss incurred by the taxpayer upon redemption of the qualified written notice of allocation is an ordinary loss

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[4] Pursuant to section 6110(j)(3) of the Internal Revenue Code of 1986 (26 U.S.C. § 6110(j)(3)), private letter rulings may not be used or cited as precedent. This private letter ruling is cited solely as evidence of administrative acceptance of the special status of cooperative stock.

> deductible for 1968 under the provisions of section 165 of the Code. See *Corn Products Refining Company* v. *Commissioner*, 350 U.S. 46 (1955), Ct. D. 1787, C.B. 1955-2, 511; *Burnet* v. *Harmel*, 287 U.S. 103 (1932), Ct. D. 611, C.B. XI-2, 210; and *Western Wine and Liquor Company* v. *Commissioner*, 18 T.C. 1090 (1952), acquiescence, C.B. 1958-1, 6. The loss is measured by the difference between the stated amount included in income in 1963 and the amount received upon redemption."

1970-1 Cum. Bull. 36, at 36.

Rev. Rul. 70-407, 1970-2 Cum. Bull. 52, held that a cotton farmer incurred an ordinary loss when, in order to recoup a loss which it had incurred, a cooperative cancelled marketing credits that had been issued to the cotton farmer in prior years.

Because of the severely depressed state of American agriculture, many farmer cooperatives have incurred losses in recent years. The decision of the United States Court of Appeals for the Eighth Circuit in *Arkansas Best* is of great concern to the farmer cooperatives and their members represented by the NCFC because it is directly contrary to the present accepted treatment of capital stock issued by cooperatives. The NCFC's members are most concerned with the Eighth Circuit's conclusion that Arkansas Best was not entitled to ordinary loss treatment on the disposition of its stock "regardless of when or why the stock was acquired" (800 F.2d 215, at 220) and, with its statement that "we do not read *Corn Products* as either requiring or permitting the courts to decide that capital stock can be anything other than a capital asset under section 1221." at 221. These conclusions suggest that losses of cooperatives and their members on capital stock (and perhaps written notices of allocation) constitute capital losses whether the stock was purchased to obtain, through the cooperative, a source of supply or a market for products or whether the stock (or notices of allocation) was received as a patronage refund on which the patron was taxed as ordinary income upon receipt. For

reasons set forth herein, the NCFC strongly believes that the conclusions of the Eighth Circuit are erroneous.

SUMMARY OF ARGUMENT

In its opinion in this case, the Eighth Circuit indicated that it believed the decisions of this Court in *Corn Products Refining Co.* v. *Commissioner*, 350 U.S. 46, 100 L.Ed. 29, 76 S.Ct. 20 (1955), and of the courts that have since followed *Corn Products* to be "misbegotten." Declining to follow the lead of other courts, the Eighth Circuit announced that Code section 1221 should be read literally and that capital stock is always a capital asset.[5]

It is respectfully submitted that these views are in error. The *Corn Products* decision was not "misbegotten." It has its roots in a long line of decisions of this Court which hold that the capital gains and losses provisions of the tax laws are to be strictly construed. This Court has so held because these provisions are exceptions to the general rule that income and loss is ordinary. The *Corn Products* decision has roots as well in another long line of decisions of this Court that hold statutes (and in particular the Code) should be construed to achieve the purpose of Congress. Moreover, this Court decided *Corn Products* upon the urging of the Government and in so doing confirmed the correctness of prior administrative practice and a number of lower court decisions.

The *Corn Products* decision is a sensible and practical approach to construing the Internal Revenue Code and, until the recent decision of the Eighth Circuit, had been accepted by the Internal Revenue Service, the courts and Congress. Decisions such as *Corn Products*, which are grounded on construing statutes based on their purpose, are essential to the proper functioning of the Federal tax system.

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[5] As noted above, the only exception recognized by the Eighth Circuit was for securities dealers holding capital stock in inventory who are subject to the rules of Code section 1236.

There is no support for the position taken by the Eighth Circuit that this Court overuled *Corn Products* by its decision in *United States* v. *Mississippi Chemical Corporation*, 405 U.S. 298, 31 L.Ed.2d 217, 92 S.Ct. 908 (1972). The Eighth Circuit attributes considerably more weight than it deserves to a reference to Code section 1221 in *Mississippi Chemical*. The authorities cited in that reference dealt only with the question of whether the amounts in issue were currently deductible or should be capitalized. The question of whether the expenditure produced a Code section 1221 "capital asset" was not at issue.

ARGUMENT

I. Corn Products and its Progeny Are Not "Misbegotten."

The Eighth Circuit's opinion asserts that "*Corn Products* and its progeny" are "misbegotten" and calls for a literal construction of Code section 1221:

> ". . . We do not read *Corn Products* as either requiring or permitting the courts to decide that capital stock can be anything other than a capital asset under section 1221. It seems to us that one of the last places where the legal system deliberately should foster subjectivity and uncertainty is in the tax code. *Corn Products* and its progeny, which we respectfully view as misbegotten, have done precisely that, leading to increased recourse to the administrative and judicial processes to resolve conflicting contentions about taxpayers' motivations in purchasing capital stock. Congress could have written section 1221 to incorporate some sort of exception regarding capital stock, just as it recognized the unique position of securities dealers in 26 U.S.C. § 1236, but it did not do so. We believe that the judiciary lacks authority to create exceptions to section 1221 that Congress did not choose to make."

800 F.2d 215, at 221.

Corn Products is not "misbegotten." It is rooted in two long lines of cases decided by this Court, one holding that the capital gains provisions should be construed narrowly and the other holding that literal compliance with the tax statutes is not sufficient if the purpose is not met.

A. This Court has consistently held that the capital asset provisions (including the term "capital asset") should be construed narrowly.

Capital gains have been accorded special treatment for Federal income tax purposes since the Revenue Act of 1921, ch. 136, 42 Stat. 227. Since *Renziehausen* v. *Lucas*, 280 U.S. 387, 74 L.Ed. 501, 50 S.Ct. 156 (1930), this Court has construed the capital gains provisions narrowly. This Court has done so by narrowly construing the term "capital asset" and also by narrowly construing the term "sale or exchange".

In *Renziehausen*, this Court held that a distiller realized ordinary income upon the sale of whiskey which had been segregated from the raw whiskey sold in the normal course of the distiller's trade or business to mature over a period of years. The whiskey was carried in a separate account entitled "Old Whiskey" in the distiller's records. This Court affirmed the holding of the lower courts that "the whiskey was clearly part of the stock in trade." 280 U.S. 387, at 389.

In *Burnet* v. *Harmel*, 287 U.S. 103, 77 L.Ed. 199, 53 S.Ct. 74 (1932), this Court held that bonus payments and royalties received by the owner of Texas oil lands for oil and gas leases constituted ordinary income. Although under Texas law the lease passed title to the oil and gas in place to the lessee and there was no specific statutory exception to capital gains treatment for oil and gas leases, this Court did not believe it would be consistent with the purpose of Congress in providing special tax treatment for sales of capital assets to treat the payments as capital:

> "Before the Act of 1921, gains realized from the sale of property were taxed at the same rates as other

> income, with the result that capital gains, often accruing over long periods of time, were taxed in the year of realization at the high rates resulting from their inclusion in the higher surtax brackets. The provisions of the 1921 revenue act for taxing capital gains at a lower rate, reënacted in 1924 without material change, were adopted to relieve the taxpayer from these excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions."

287 U.S. 103, at 106.

This Court concluded that treating gain as capital "would have tended to defeat rather than further the purpose of the Act." 287 U.S. 103, at 108.

In *Fairbanks* v. *United States*, 306 U.S. 436, 83 L.Ed. 855, 59 S.Ct. 607 (1939), this Court affirmed administrative practice and the lower courts when it held that gain realized upon the redemption of bonds did not result in a "capital gain" because "payment and discharge of a bond is neither sale nor exchange within the commonly accepted meaning of the words." 306 U.S. 436, at 437. By the time this Court rendered its decision, the statute had been amended for 1934 and later years by adding what is now Code section 1271(a)(1) to provide capital gains treatment for redemptions. This and other examples of the interplay between court decisions and Congressional actions listed below illustrate how Congress has monitored court decisions in this area. Where Congress has felt that changes are required, it has acted.

In *Hort* v. *Commissioner*, 313 U.S. 28, 85 L.Ed. 1168, 61 S.Ct. 757 (1941), this Court held that a lump sum payment for cancellation of a lease that had nine years to run was ordinary income to the lessor. This Court accepted Hort's characterization of the lease as "property" but did not feel

compelled to treat the cancellation payment as capital simply because there was no explicit statutory exception for lease cancellation payments:

> "Simply because the lease was 'property' the amount received for its cancellation was not a return of capital, quite apart from the fact that 'property' and 'capital' are not necessarily synonymous in the Revenue Act of 1932 or in common usage. Where, as in this case, the disputed amount was essentially a substitute for rental payments which § 22(a) expressly characterizes as gross income, it must be regarded as ordinary income, and it is immaterial that for some purposes the contract creating the right to such payments may be treated as 'property' or 'capital'."

313 U.S. 28, at 31.

In 1954, Congress added what is now Code section 1241 to treat payments made to a lessee for cancellation of a favorable lease as capital gain, but left the result in *Hort* unchanged.

In *Helvering* v. *Flaccus Leather Co.*, 313 U.S. 247, 85 L.Ed. 1310, 61 S.Ct. 878 (1941), this Court held that insurance proceeds received by a corporation as compensation for the loss by fire of buildings, machinery and equipment were ordinary income because there was no "sale or exchange." This result was changed by Congress in 1942 with the addition of what is now Code section 1231(a)(3)(A)(ii).

In *Kieselbach* v. *Commissioner*, 317 U.S. 399, 87 L.Ed. 358, 63 S.Ct. 303 (1943), this Court held that a portion of the proceeds received from the condemnation by the City of New York of land was ordinary income since the portion was "paid to the taxpayers in lieu of what they might have earned on the sum found to be the value of the property on

the day the property was taken." 317 U.S. 399, at 403. This Court then stated:

> "... petitioner contends that as just compensation requires the payment of these sums for delay in settlement, they are a part of the damages awarded for the property. But these payments are indemnification for delay, not a part of the sale price. While without their payment just compensation would not be received by the vendor, it does not follow that the additional payments are a part of the sale price under § 117(a) [the predecessor to Code section 1221]. The just compensation constitutionally required is not the same thing as the sale price of a capital asset."

317 U.S. 399, at 404.

In *Watson* v. *Commissioner*, 345 U.S. 544, 97 L.Ed. 1232, 73 S.Ct. 848 (1953), this Court held that a portion of the proceeds received from the sale of an orange grove should be allocated to the growing crop and treated as ordinary income. Responding to decisions of lower courts on this issue, in 1951 Congress amended the statute by adding what is now Code section 1231(b)(4) to make it clear that gain attributable to unharvested crops in circumstances similar to those in *Watson* was capital.

The next decision in this line is *Corn Products Refining Co.* v. *Commissioner*, *supra*. In *Corn Products*, this Court summarized the holdings of some of its prior decisions regarding the definition of capital assets as follows:

> "But the capital-asset provision of § 117 must not be so broadly applied as to defeat rather than further the purpose of Congress. *Burnet* v. *Harmel*, 287 U.S. 103, 108. Congress intended that profits and losses arising from the everyday operation of a business be considered as ordinary income or loss rather than capital gain or loss. The preferential treatment provided by § 117 applies to transactions in property which are not the normal source of business income. It was intended 'to

> relieve the taxpayer from . . . excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions.' *Burnet* v. *Harmel*, 287 U.S., at 106. Since this section is an exception from the normal tax requirements of the Internal Revenue Code, the definition of a capital asset must be narrowly applied and its exclusions interpreted broadly. This is necessary to effectuate the basic congressional purpose. This Court has always construed narrowly the term 'capital assets' in § 117. See *Hort* v. *Commissioner*, 313 U.S. 28, 31; *Kieselbach* v. *Commissioner*, 317 U.S. 399, 403."

350 U.S. 46, at 52.

Subsequent cases have reaffirmed the approach taken by this Court to the construction of the capital asset definitions contained in the tax laws. In *Commissioner* v. *P. G. Lake, Inc.*, 356 U.S. 260, 2 L.Ed.2d 743, 78 S.Ct. 691 (1958), this Court held that payments for oil and gas rights and sulphur rights were ordinary income even though under Texas law oil payments are interests in land. This Court held:

> "The purpose of § 117 was 'to relieve the taxpayer from . . . excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions.' See *Burnet* v. *Harmel*, 287 U.S. 103, 106. And this exception has always been narrowly construed so as to protect the revenue against artful devices. See *Corn Products Refining Co.* v. *Commissioner*, 350 U.S. 46, 52.
>
> We do not see here any conversion of a capital investment . . .
>
> * * *
>
> These arrangements seem to us transparent devices. Their forms do not control. Their essence is determined

not by subtleties of draftsmanship but by their total effect."

356 U.S. 260, at 265 and 266-267.

In *Commissioner* v. *Gillette Motor Transport*, 364 U.S. 130, 4 L.Ed.2d 1617, 80 S.Ct. 1497 (1960), this Court held that compensation received by the taxpayer for a temporary taking of its facilities during World War II was ordinary income. This Court stated:

> "While a capital asset is defined in § 117(a)(1) as 'property held by the taxpayer,' it is evident that not everything which can be called property in the ordinary sense and which is outside the statutory exclusions qualifies as a capital asset. This Court has long held that the term 'capital asset' is to be construed narrowly in accordance with the purpose of Congress to afford capital-gains treatment only in situations typically involving the realization of appreciation in value accrued over a substantial period of time, and thus to ameliorate the hardship of taxation of the entire gain in one year. *Burnet* v. *Harmel*, 287 U.S. 103, 106. Thus the Court has held that an unexpired lease, *Hort* v. *Commissioner*, 313 U.S. 28, corn futures, *Corn Products Co.* v. *Commissioner*, 350 U.S. 46, and oil payment rights, *Commissioner* v. *P. G. Lake, Inc.*, 356 U.S. 260, are not capital assets even though they are concededly 'property' interests in the ordinary sense. And see, Surrey, Definitional Problems in Capital Gains Taxation, 69 Harv. L. Rev. 985, 987-989 and Note 7.
>
> In the present case, respondent's right to use its transportation facilities was held to be a valuable property right compensable under the requirements of the Fifth Amendment. However, that right was not a capital asset within the meaning of §§ 117(a)(1) and 117(j)."

364 U.S. 130, at 134-135.

In *United States* v. *Midland-Ross Corp.*, 381 U.S. 54, 14 L.Ed.2d 214, 85 S.Ct. 1308 (1965), this Court held that original issue discount was ordinary income even though "original issue discount becomes property when the obligation falls due or is liquidated prior to maturity and § 117(a)(1) defined a capital asset as 'property held by the taxpayer,' . . ." 381 U.S. 54, at 56. This Court quoted from the passage in *Gillette Motor* set forth above and then stated:

> "In applying this principle, this Court has consistently construed 'capital asset' to exclude property representing income items or accretions to the value of a capital asset themselves properly attributable to income."

381 U.S. 54, at 57.

Congress has since essentially codified the holding of *Midland-Ross* in sections 1271 to 1288 of the Code.

Finally, in *Malat* v. *Riddell*, 383 U.S. 569, 16 L.Ed.2d 102, 86 S.Ct. 1030 (1966), this Court provided guidance in an area that has resulted in much litigation, namely, when does real estate become "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business" within the meaning of Code section 1221(1). This Court held:

> "The purpose of the statutory provision with which we deal is to differentiate between the 'profits and losses arising from the everyday operation of a business' on the one hand (*Corn Products Co.* v. *Commissioner*, 350 U.S. 46, 52) and 'the realization of appreciation in value accrued over a substantial period of time' on the other. (*Commissioner* v. *Gillette Motor Co.*, 364 U.S. 130, 134.) A literal reading of the statute is consistent with this legislative purpose. We hold that, as used in § 1221(1), 'primarily' means 'of first importance' or 'principally'."

383 U.S. 569, at 572.

Congress has made efforts over the years to clarify the law in this area commencing in 1954 with the addition of Code section 1237.

These cases taken together show that this Court has consistently construed the capital asset provisions narrowly because they represent an exception to the usual tax rules treating income and losses as ordinary. The *Corn Products* case is one case in this line. The Eighth Circuit's approach to construing Code section 1221 in *Arkansas Best* is inconsistent with these cases and should be reversed.

B. Taxation statutes are not literally construed when a literal construction is inconsistent with the intent of the statute.

When this Court put what the Eighth Circuit describes as a "judicial gloss", 800 F.2d 215, at 219, on Code section 1221 in *Corn Products*, it was not only construing the capital asset provisions narrowly but it was also acting in a manner consistent with many prior cases interpreting the revenue laws. In *Corn Products* this Court started from the assumption that "petitioner's corn futures do not come within the literal language of the exclusions set out in that section [117(a)]." 350 U.S. 46, at 51. However this Court then observed that:

> "Since this section [117] is an exception from the normal tax requirements of the Internal Revenue Code, the definition of a capital asset must be narrowly applied and its exclusions interpreted broadly. *This is necessary to effectuate the basic congressional purpose.*" (emphasis added).

350 U.S. 46, at 52.

This Court has always sought to interpret the revenue laws as it did in *Corn Products* in a manner that ensures their purpose will be achieved.

For instance, it has long been established that literal compliance with the reorganization provisions is not sufficient to ensure tax-free treatment of a transaction. In *Pinellas Ice Co.* v. *Commissioner*, 287 U.S. 46, 77 L.Ed. 428, 53 S.Ct. 257 (1933), although the statute did not so require, this Court held that to qualify as a tax free reorganization:

> "... the seller must acquire an interest in the affairs of the purchasing company more definite than that incident to ownership of its short-term purchase-money notes."

287 U.S. 462, at 470.

In *Gregory* v. *Helvering*, 293 U.S. 465, 79 L.Ed. 596, 55 S.Ct. 266 (1935), this Court held that a transaction which was in form a reorganization was in fact a dividend. In so holding, this Court determined that:

> "... the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose."

293 U.S. 465, at 470.

In *LeTulle* v. *Scofield*, 308 U.S. 415, 84 L.Ed. 355, 60 S.Ct. 313 (1940), this Court held that a reorganization was not tax-free where the consideration received was cash and long-term bonds. This Court prefaced its discussion of the reorganization provisions with the following observation:

> "As the court below properly stated, the section is not to be read literally, as denominating the transfer of all the assets of one company for what amounts to a cash consideration given by the other a reorganization."

308 U.S. 415, at 420.

In *Helvering* v. *Alabama Asphaltic Limestone Co.*, 315 U.S. 179, 86 L.Ed. 775, 62 S.Ct. 540 (1942), this Court stated:

> "From the *Pinellas* case (287 U.S. 462) to the *LeTulle* case (308 U.S. 415) it has been recognized that a transaction may not qualify as a 'reorganization' under the various revenue acts though the literal language of the statute is satisfied."

315 U.S. 179, at 182.

In *Bazley* v. *Commissioner*, 331 U.S. 737, 91 L.Ed. 1782, 67 S.Ct. 1489 (1947), this Court held a purported recapitalization to be taxable after making the following observations:

> "Application of the language of such a revenue provision is not an exercise in framing abstract definitions. In a series of cases this Court has withheld the benefits of the reorganization provision in situations which might have satisfied provisions of the section treated as inert language, because they were not reorganizations of the kind with which § 112, in its purpose and particulars, concerns itself. See *Pinellas Ice & Cold Storage Co.* v. *Commissioner*, 287 U.S. 462; *Gregory* v. *Helvering*, 293 U.S. 465; *LeTulle* v. *Scofield*, 308 U.S. 415."

331 U.S. 737, at 741.

Most recently, in *Paulsen* v. *Commissioner*, 469 U.S. 131, 83 L.Ed.2d 540, 105 S.Ct. 627 (1985), this Court reiterated these views.

> "Satisfying the literal terms of the reorganization provisions, however, is not sufficient to qualify for nonrecognition of gain or loss. The purpose of these provisions is "to free from the imposition of an income tax purely 'paper profits or losses' wherein there is no realization of gain or loss in the business sense but merely the recasting of the same interests in a different form." [citations omitted]."

469 U.S. 131, at 136.

In *Griffiths* v. *Commissioner*, 308 U.S. 355, 84 L.Ed. 319, 60 S.Ct. 277 (1939), this Court looked through an arrangement which was cast in form as an installment sale, but was in reality not an installment sale, with the following observation:

> "Legislative words are not inert, and derive vitality from the obvious purposes at which they are obtained, particularly in the provisions of a tax law like those governing installment sales in § 44 of the Revenue Act of 1932."

308 U.S. 355, at 358.

More recent examples of this Court construing the language of the tax laws are found in *Bob Jones University* v. *United States*, 461 U.S. 574, 76 L.Ed.2d 157, 103 S.Ct. 2017 (1983) and in *Hillsboro National Bank* v. *Commissioner*, 460 U.S. 370, 75 L.Ed.2d 130, 103 S.Ct. 1134 (1983). In *Bob Jones*, this Court held that:

> "... to warrant exemption under § 501(c)(3), an institution must fall within a category specified in that section and must demonstrably serve and be in harmony with the public interest."

461 U.S. 574, at 592.

In reaching this conclusion, this Court started from the premise that:

> "It is a well-established canon of statutory construction that a court should go beyond the literal language of a statute if reliance on that language would defeat the plain purpose of the statute ..."

461 U.S. 574, at 586.

In *Hillsboro*, this Court held that the tax benefit rule (which was described by this Court as a "judicially developed principle that allays some of the inflexibilities of the annual accounting system", 460 U.S. 370, at 377), overrides the clear language of section 336 of the Code.

The *Corn Products* decision is consistent with these and other decisions of this Court that construe the specific language of the tax laws in a manner designed to ensure that the Congressional purpose is achieved. The Eighth Circuit decision in *Arkansas Best* does not construe the language of Code section 1221 in such a manner and thus should be reversed.

C. *Corn Products* was decided as it was at the urging of the Government, and it confirmed prior administrative practice and lower court decisions.

In considering *Corn Products*' roots, it should be remembered that it was decided as it was at the urging of the Government, and it confirmed prior administrative practice as well as lower court decisions.

The Government's Brief in *Corn Products*[6] argued strongly for the approach this Court ultimately took in its opinion:

> "A. In general, under the Code the annual profits derived from the ordinary carrying on of a trade or business are taxed as ordinary income. Preferential treatment is, however, accorded by Section 117 to the results of dealings in property, called capital assets, that are not the normal, direct source of business profits. The definition of a capital asset in Section 117 embodies an unusual draftsman's technique—the definition is specific only in stating what is *not* a capital asset. Taxpayer argues that because futures contracts do not fall strictly within the exclusions from Section 117 they must be held to be capital assets notwithstanding that they were employed, as held by both lower courts, as an integral part of the day-to-day operations of taxpayer's manufacturing business.
>
> Taxpayer's approach ignores the settled rule that the scope of the preferential capital gains provisions of the

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[6] Brief for the Petitioner, *Corn Products Refining Co.* v. *Commissioner*, *supra*, at 11-12 and 27.

Code is to be strictly construed. Thus in *Burnet* v. *Harmel*, 287 U.S. 103, 106, one of the first cases to reach this Court following the inclusion of capital gains provisions in the income tax law, the Court indicated that the new provisions were to be strictly construed to effect the congressional purpose of relieving the taxpayer from the 'excessive tax burdens on gains resulting from a conversion of capital investments' which it noted would often have accrued 'over long periods of time.' A necessary corollary of the rule that the capital asset definition of Section 117 is to be narrowly applied is that the exclusions from the capital asset definition shall be broadly applied so as not to frustrate the congressional purpose of limiting the preferential treatment to property in the nature of investments, not employed as an integral part of the day-to-day income producing activity of the taxpayer."

at 11-12.

"As this Court has indicated, the capital gains provisions must be read in the light of their purpose and in the context of the pattern of the income tax law which taxes ordinary income at full rates and grants exceptional treatment to capital gains and losses. So read, it becomes evident that Congress has made it as clear as the limitations of language permit (short of a detailed enumeration of every conceivable kind of transaction which might be found in every conceivable type of business) that profits and losses derived from the normal operation of a business are not to receive the special tax considerations reserved for what, generally, may be described as investments."

at 27.

In its opinion in *Corn Products*, this Court accepted these arguments. This Court also rested its decision on prior administrative practice as well as lower court decisions:

> "The problem of the appropriate tax treatment of hedging transactions first arose under the 1934 Tax Code revision. Thereafter the Treasury issued G.C.M. 17322, *supra*, distinguishing speculative transactions in commodity futures from hedging transactions. It held that hedging transactions were essentially to be regarded as insurance rather than a dealing in capital assets and that gains and losses therefrom were ordinary business gains and losses. The interpretation outlined in this memorandum has been consistently followed by the courts as well as by the Commissioner. While it is true that this Court has not passed on its validity, it has been well recognized for 20 years; and Congress has made no change in it though the Code has been re-enacted on three subsequent occasions. This bespeaks congressional approval."

350 U.S. 46, at 52-53.

Thus, the *Corn Products* decision was well-grounded on prior decisions of this Court, administrative practice and lower court decisions. The Eighth Circuit's suggestion that the decision was "misbegotten" is clearly erroneous.

II. THE *CORN PRODUCTS* DECISION IS A SENSIBLE AND PRACTICAL APPROACH TO CONSTRUING THE INTERNAL REVENUE CODE AND, UNTIL THE RECENT DECISION OF THE EIGHTH CIRCUIT, HAD BEEN ACCEPTED BY THE INTERNAL REVENUE SERVICE, THE COURTS AND CONGRESS.

The *Corn Products* decision has achieved broad acceptance since it was rendered in 1955 because it represents a sensible and practical approach to construing the Internal Revenue Code. Because the distinction between the treatment of gain or loss as ordinary or capital has made such a difference

under the tax laws and because the economic world is so varied and complex, it has been inevitable that a number of disputes have arisen as to where to draw the line between capital and ordinary. Decisions like *Corn Products*, which are grounded on construing statutes based upon their purpose, are essential to the proper functioning of the Federal tax system.

A. The Internal Revenue Service has, at least until recently, embraced the *Corn Products* decision and confirmed its applicability to capital stock.

As noted above the *Corn Products* decision represented an Internal Revenue Service victory. In numerous subsequent cases and in published rulings, the Internal Revenue Service embraced the rationale of *Corn Products* and aggressively argued that gains on the disposition of property acquired and held for business rather than investment purposes resulted in ordinary income.

For instance, in 1957, in its petition to this Court for a writ of certiorari in the *P. G. Lake* case,[7] the Government argued:

> "This Court has held that the capital gains provisions are to be 'narrowly applied' so as to effectuate the congressional policy of taxing at ordinary income rates the profits 'arising from the everyday operation of a business' while, at the same time, limiting preferential capital gain treatment 'to transactions in property which are not the normal source of business income.' *Corn Products Co.* v. *Commissioner*, 350 U.S. 46, 52. And, as the *Corn Products* case demonstrates, a transaction may fit the literal language of the statute and yet not qualify for capital gain treatment where it does not fall within the obvious purpose of Congress and where a taxpayer would otherwise be able (pp. 53-54) 'to transmute ordinary income into capital gain at will.' Such is the situation here."

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[7] Petitioner's Brief for Certiorari, *Commissioner* v. *P. G. Lake, Inc.*, *supra*, at 17.

at 17.

In 1958, in *Rev. Rul. 58-40*, 1958-1 Cum. Bull. 275, relying principally upon *Corn Products*, the Internal Revenue Service ruled that stock, government bonds and debentures could give rise to ordinary income and loss in appropriate circumstances. In the examples in the ruling, the stock and debentures were purchased to obtain a source of supply of inventory. The government bonds were purchased in accordance with the terms of a contract and placed in escrow to guarantee performance under the contract. In *Rev. Rul. 58-40*, the Internal Revenue Service announced its acquiescence in two Tax Court cases which treated capital stock as an ordinary asset. *Western Wine & Liquor Co.*, 18 T.C. 1090 (1952), acq. 1958-1 Cum. Bull. 6 and *Charles A. Clark*, 19 T.C. 48 (1952), acq. 1958-1 Cum. Bull. 7. In its brief in the *Corn Products* case,[8] the Government had cited these cases (as well as *Commissioner* v. *Bagley & Sewall Co.*, 221 F.2d 944 (2nd Cir. 1955), a case involving escrowed government bonds, and several other cases) for the following proposition:

> "Significant, too, are decisions refusing capital gain or loss treatment to property which served a purpose directly related to the earning of normal business profits, even though the property did not come within the literal language of the statutory exceptions to the capital asset definition."

at 22.

In 1959, in its brief to this Court in *Gillette Motor Transport*,[9] the Government argued (citing among other cases *Corn Products*):

> "Section 117(a)(1) defines the term 'capital assets' generally as 'property' held by the taxpayer. However,

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[8] Brief for the Petitioner, *Corn Products Refining Co.* v. *Commissioner*, *supra*, at 22.

[9] Brief for the Petitioner, *Commissioner* v. *Gillette Motor Transport*, *supra*, at 17-18.

> 'property' as used in that section is not all-inclusive. The Congressional purpose in allowing a lower rate of taxation on the gain resulting from the conversion of capital assets is to ameliorate the burden which would be incurred by a taxpayer should that gain be classified as ordinary income in the year of a sale or exchange when the gain is due to appreciation in value over the period of investment, and to remove the deterrent effect of that burden on such conversions. [citations omitted]. This Court, in order to conform the statutory definition of 'capital assets' to that Congressional purpose, has always narrowly construed the definition. [citations omitted]."

at 17-18.

In *Rev. Rul. 70-64, supra*, (discussed in detail above), *Corn Products* and other cases were cited as the basis for concluding that the loss incurred by a chicken farmer on qualified written notices of allocation received from a farmers' cooperative was ordinary.

In *Rev. Rul. 72-238*, 1972-1 Cum. Bull. 65, *Corn Products* and *Gillette Motor Transport* were cited as the basis for concluding that gain realized by a bank in a foreclosure proceeding was ordinary income. Comparing the situation with that in *Corn Products*, the Internal Revenue Service stated:

> "Likewise, the gain involved here arises from the ordinary operation of the banking business."

1972-1 Cum. Bull. 65, at 66.

In *Rev. Rul. 75-13*, 1975-1 Cum. Bull. 67, the Internal Revenue Service again ruled, citing *Corn Products*, that the sale of stock could give rise to ordinary gain or loss. The ruling reviewed the holding of this Court in *Corn Products* and then stated:

> "In the light of the *Corn Products* case, subsequent courts have indicated that whether the sale or exchange of shares of stock gives rise to ordinary, as opposed to

> capital, gain or loss depends upon whether the taxpayer purchased and held the stock with a predominant business motive as distinguished from a predominant investment motive. Motive is determined by analyzing all the surrounding facts and circumstances."

1975-1 Cum. Bull. 67, at 68.

This ruling was revoked by *Rev. Rul. 78-94*, 1978-1 Cum. Bull. 58. In *Rev. Rul. 78-94*, the Internal Revenue Service continued to adhere to the view that the sale of stock can give rise to ordinary gain or loss, but it shifted the emphasis of the test which it believed proper to apply:

> "Revenue Ruling 75-13 is revoked since it is now the Service's position that even a predominant business motive cannot preclude the stock from capital gain or loss treatment, as long as there was a substantial investment motive for acquiring or holding the stock."

1978-1 Cum. Bull. 58, at 58.

While it might be questioned whether this shift of emphasis is proper given this Court's clear direction over the years that the capital provisions are to be narrowly construed, even in *Rev. Rul. 78-94* the Internal Revenue Service continued to recognize that there were circumstances where stock could be an ordinary asset.

In *Rev. Rul. 78-396*, 1978-2 Cum. Bull. 114, the Internal Revenue Service held that a foreign exchange loss incurred by a bank was under the circumstances ordinary "because the currency transaction did not have any substantial investment purpose, but was directly related to the taxpayer's business." 1978-2 Cum. Bull. 114, at 115. The ruling cites *Corn Products*.

B. *Corn Products* has been applied by lower courts in many cases over the past thirty years and no court, until the Eighth Circuit, thought it "misbegotten".

There have been literally hundreds[10] of decisions over the past 30 years that have applied the standards set forth in this Court's decision in *Corn Products* to a broad range of factual situations. Many of the cases have involved stock and have confirmed that, in appropriate circumstances, sales of stock may give rise to ordinary income or loss. See, *e.g.*, *Campbell Taggart, Inc.* v. *United States*, 744 F.2d 442 (5th Cir. 1984). The lower courts have found the concept set forth in *Corn Products* to be reasonable and workable. The focus of these courts on the purpose for acquiring and holding an asset is the proper focus. This Court should not depart from that approach at this late date.

C. Congress has accepted the result of the *Corn Products* case.

Since the *Corn Products* case was decided in 1955, Congress has revised the Internal Revenue Code on many occasions. Significant changes were made in 1958, 1962, 1964, 1969, 1971, 1974, 1976, 1978, 1981, 1982, 1984, and most recently in 1986. The changes in 1986 were so significant that Congress decided to rename the the Internal Revenue Code the Internal Revenue Code of 1986.

Congress has not amended the Internal Revenue Code to change the result of *Corn Products* and the numerous cases interpreting *Corn Products*. This is evidence of Congressional approval. See, *Corn Products*, 350 U.S. 46, at 52-53. Even a cursory review of Subchapter P (Capital Gains and Losses) of the Code (sections 1201-1288) reveals the time and effort that Congress has devoted over the years to distinguishing between capital gains and losses. Many of the special provisions contained in Subchapter P were Congressional

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[10]CCH current citator (through 4/8/87) lists 263 decisions that cite this Court's decision in *Corn Products*. *CCH 1987 Standard Federal Tax Reports, Citator (A-L)*.

responses to decisions of this and other courts (a few were noted above). Under the circumstances, the absence of a provision in the Code aimed at reversing *Corn Products*, and the cases that have followed it, is even stronger evidence of Congressional approval of the decision than might normally be the case where there is Congressional silence.

Congress is clearly aware of *Corn Products* and its implications. For instance, in 1986 Congress added Code section 988 to the Code to provide greater certainty as to the treatment of exchange gains and losses. Both the House Ways and Means and Senate Finance Committee Reports discussed the application of *Corn Products* to foreign currency transactions:

> "The term 'capital asset' includes all classes of property not specifically excluded by Section 1221 of the Code. Foreign currency generally falls within the definition of a capital asset; however, under *Corn Products Refining Co.* v. *Commissioner*, 350 U.S. 46 (1955), property that satisfies the literal language of section 1221 of the Code is not considered a capital asset if the property is used by the taxpayer as an integral part of a trade or business."

H.R. Rep. No. 426, 99th Cong., 1st Sess., 450 (note 19) (1985) and S. Rep. No. 313, 99th Cong., 2d Sess., 434 (note 5) (1986).

III. *MISSISSIPPI CHEMICAL* DID NOT REVERSE *CORN PRODUCTS SUB SILENTIO*.

The Eighth Circuit sought to rely on this Court's decision in *Mississippi Chemical* for support of its mistaken view that capital stock is always a capital asset. The Eighth Circuit's reliance is misplaced.

In *Mississippi Chemical* this Court was faced with the question as to whether certain amounts paid by Mississippi Chemical Corporation and Coastal Chemical Corporation, two fertilizer manufacturing cooperatives located in Mississippi, to purchase Class C stock of the New Orleans Bank for Cooperatives, which is also a cooperative, constituted additional interest costs of loans they had outstanding with the Bank.

The Farm Credit Act of 1955 provided for three classes of stock for the banks for cooperatives such as the New Orleans Bank for Cooperatives—Classes A, B and C. *Mississippi Chemical*, 405 U.S. 298, at 305. The class of stock which was the subject of the controversy in *Mississippi Chemical* was the Class C stock. Class C stock could only be issued to farmers cooperative associations. The stock could be acquired under only four circumstances:

> (1) One share was required to be purchased to initially qualify any association as a borrower from a district bank.
>
> (2) Each borrower was required to make quarterly stock purchases.
>
> (3) Class C stock could be issued as patronage refunds.
>
> (4) Borrowers received at the end of each fiscal year an "allocated surplus" credit payable out of the bank's net savings. When the surplus amount reaches 25% of the total outstanding capital stock of the bank, the excess could be distributed as Class C stock.

405 U.S. 298, at 306 and 307.

Only the tax treatment of the quarterly purchases of Class C stock was in dispute. 405 U.S. 298, at 307. The characterization of the Class C stock purchased by taxpayer as a capital asset was fixed as a capital asset on taxpayer's tax return. 405 U.S. 298, at 300.[11] The only issue before this Court was whether any portion of the purchase price of the quarterly stock purchase was in fact deductible as a "hidden" interest charge. 405 U.S. 298, at 300, 307 and 310. This Court discussed the various characteristics of the purchased Class C stock which affected its value and concluded that the stock was part of an overall scheme of financing for cooperatives which had a value over the long run. 405 U.S. 298, at 310 and 311. Even though the Government conceded that the stock was not worth the face amount of $100, this Court

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[11] Also see *Mississippi Chemical Corporation* v. *United States*, 431 F.2d 1320 (5th Cir. 1970), at 1321.

found that the stock had long-term value of $100 per share. 405 U.S. 298, at 311-312.

In its discussion of the character and value of the purchased stock this Court stated:

> "Since the security is of value in more than one taxable year, it is a capital asset within the meaning of § 1221 of the Internal Revenue Code, and its cost is nondeductible. Cf. *Commissioner* v. *Lincoln Savings & Loan Association*, 403 U.S. 345 (1971); *Old Colony R. Co.* v. *United States*, 284 U.S. 552 (1932); 26 CFR § 1.461-1."

405 U.S. 298, at 310.

It is respectfully submitted that the Eighth Circuit has accorded this reference to Code section 1221 significantly more weight than it deserves:

1) The three cited authorities all deal with whether an expenditure was deductible as an expense or had to be capitalized. No reference was made in these authorities to Code section 1221 or its predecessor, section 117 of the 1939 Code.

2) The reference to Code section 1221 was dicta as Code section 1221 was not at issue. The taxpayers in *Mississippi Chemical* had treated the purchased stock as a Code section 1221 asset on their respective returns. The only issue before the court in *Mississippi Chemical* was what portion of the payments made had to be capitalized as part of the purchase price.

3) The authorities cited in the above quotation deal with the timing of deductions, not whether the assets were capital assets.

4) Neither *Corn Products* nor the character of the asset to which payments were being allocated was at issue in *Mississippi Chemical*.

In summary, we find no support in this Court's opinion in *Mississippi Chemical* for the proposition that the holding of *Corn Products* does not apply to capital stock. The Eighth Circuit's reliance on *Mississippi Chemical* as support for its

attempt to overrule this Court's decision in *Corn Products*, is, to use the Eighth Circuit's terminology, "misbegotten".

CONCLUSION

The National Council of Farmer Cooperatives respectfully urges this Court to determine that the United States Court of Appeals for the Eighth Circuit was in error when it held that capital stock (other than that held in inventory by a securities dealer) must always be treated as a capital asset without regard to the reasons the stock was purchased and held.

May 5, 1987

Respectfully submitted,

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